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No. 85-519

Supreme Court, U.S.
FILED
JAN 6 1986
JOSEPH F. SPANIOL, JR.
CLERK

IN THE SUPREME COURT OF THE UNITED STATES

October Term, 1985

DR. WILLIAM C. RANDALL, DR. ROGER E. AUSTIN, DR. TOM W. ANDERSON and DR. MYREL A. NEUMANN,

Petitioners,

v.

B. J. LOFTSGAARDEN; ALOTEL INCORPORATED, a Minnesota corporation; PROPERTY DEVELOPMENT AND RESEARCH COMPANY, a Minnesota corporation; and 2361 BUILDING CORPORATION, a Minnesota corporation,

Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

BRIEF AMICUS CURIAE OF HON INDUSTRIES, INC.

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This brief is in support of the petitioner. It is filed with the consent of all of the parties.

INTEREST OF HON INDUSTRIES, INC.

HON INDUSTRIES, INC. has an interest in this case in that it is a plaintiff in an action pending in the U.S. District Court, Southern District of Ohio, Western Division (Civil Action C-1-83-793). That case involves allegations of fraud in the sale of tax shelter securities and seeks damages under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. An important issue in the resolution of that case is whether a damage award should be reduced by tax benefits received by an investor, which is precisely the same issue to be decided in this case.

SUMMARY

The primary function of the fraud remedies of Section 12(2) of the Securities Act of 1933 (the "Securities Act") and Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act") and Rule 10b-5 thereunder is to deter persons from violations of the full and fair disclosure provisions of the securities laws. Assuring that investors who have been defrauded is also a goal, but only a secondary one.

This case involves a situation where damages calculated on a basis which would deter violations (whereby damages are not reduced by tax benefits) would yield more than damages calculated on a basis to compensate the investor (whereby damages are reduced by tax benefits)

and arguably the damage award which implements a deterrence theory more than compensates the investor for his loss.

Where there is a choice between damage theories, the one which implements the more important goal should be chosen. Here, the goal of deterrence is more important and tax benefits should not reduce damages.

While a damage theory based upon deterrence is not without limit, the one limitation which might be pertinent here is not applicable because of fact differences. That limitation allows a fraudulent party to reduce his damages to the extent that he can show that after the fraud he created extraordinary gains as a result of his special efforts. It is not applicable here because the benefits which the seller now wishes to take credit for were foreseen and

the seller's[1] efforts resulted in foreclosure, not extraordinary gain.

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[1] In this brief, the defendant Loftsgaarden is sometimes referred to as the seller. It should be noted that the term seller is also sometimes used generically.

ARGUMENT

INTRODUCTION

The Court of Appeals decided that the tax benefits which an investor receives as a result of his investment in a tax shelter security must reduce the amount of the damages the investor would otherwise receive under the fraud remedies of Section 12(2) of the Securities Act and Rule 10b-5 under the Exchange Act. That decision was based on the view that the "nature of damages in private securities fraud actions" is "strictly compensatory" and that damages are limited by the "extent [to which] damages are inflicted on the plaintiffs."[2]

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[2] J.A. A-11

We believe that the fraud remedies of Section 12(2) and Rule 10b-5 are not "strictly compensatory." While compensating defrauded investors is certainly one of the functions of the fraud remedies, it is not the primary function. Deterring sellers from violating the disclosure provisions of the two Acts is the function which is primary; and reducing a damage award by tax benefits conflicts with, and seriously undermines, that function. We believe that in order to implement the goal of deterrence, tax benefits should be ignored.

TWO IMPORTANT ASPECTS OF THE TAX LOSSES

By way of introduction to the argument below, we want to note two facts about the tax losses generated by the partnership here, facts which we believe

are important to the argument.

First, the tax losses were foreseeable by the seller at the time he fraudulently sold the securities. The seller had, in fact, projected some of the tax losses and had included these projected tax losses in the private placement memorandum distributed to investors.[3] More importantly, the seller was able to project most or all of the additional losses; that is, the losses which were not projected in the private placement memorandum but which were incurred and which led to foreclosure. For example, one of the main reasons for losses was the interest rate on the construction loan. The seller had projected the

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[3] J.A. D-7

interest rate to be 9.5%, but the seller knew it would exceed 9.5% (because the rate floated 4% above prime and at the time the securities were sold, prime was already in excess of 7%).[4] As a result, the seller could foresee most of the losses which were incurred by the partnership, losses he now wants to use to reduce the amount of damages he must pay.

Second, the tax losses which the seller now wants to take advantage of did not flow from any meritorious efforts or talents of the seller. Most of the tax losses which had been projected by the seller in the private placement memoranda resulted from depreciation and interest deductions, which are

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[4] J.A. E-2, E-3, E-4

passive-type deductions which do not result from the seller's efforts and are available in all instances where, as the case may be, the property is owned or it is acquired by debt financing. Most of the additional losses resulted primarily from the fact that the project operated at a real cash loss. Indeed, the operating losses were far greater than projected in the private placement memorandum. These cash losses from operations translated directly on a dollar-for-dollar basis into tax losses.

THE OVERALL GOAL OF FEDERAL SECURITIES LAWS IS FULL AND FAIR DISCLOSURE

In deciding whether tax benefits should reduce a damage award, this Court should be guided primarily by considera-

tions of the policies underlying the Federal securities laws in general and the fraud remedies in particular because the language of the two statutes insofar as they relate to damages is not particularly helpful. Section 28 of the Exchange Act speaks in terms of "actual damages" without specifying the components of damages. Section 12(2) is more specific with its "less. . . income" language, but perhaps not more helpful since it is certainly possible to construe the term "income" narrowly (to include only dividends, distributions and proceeds of resale) or broadly (to also include tax benefits).

What follows is a very brief discussion of the general purpose of Federal securities laws. While we do not think that there can be any serious disagreement about that purpose, we feel that

the discussion is useful because it puts the fraud remedies of Section 12(2) and Rule 10b-5 in context, and suggests the policies which the fraud remedies are intended to implement.

A review of the legislative histories of the Securities Act and the Exchange Act indicates that the general purpose of the Federal securities laws is to assure that investors are provided with accurate and adequate information, which they can use to make informed investment decisions.

For example, the Senate Report on the Securities Act indicates that Congress believed that providing accurate disclosure to investors was the primary purpose of the Act and that such disclosure would lead to efficient functioning of the securities market and to rational allocation of capital resources.

The Report said:

> The aim [of the Act] is to. . . place adequate and true information before the investor. . . [in order] to restore the confidence of the prospective investor in his ability to select sound securities [and] to bring into productive channels of industry and development capital which has grown timid to the point of hoarding.

S.Rep. No. 47, 73rd Cong. 1st Sess. 1 (1933) (accompanying S. 875)

THE FUNCTION OF THE FRAUD REMEDIES IS DETERRENCE

The primary function of the fraud remedies of Section 12(2) and Rule 10b-5 is to further the general purpose of the securities laws; that is, their function is to promote full and fair disclosure. The fraud remedies do this by imposing a measure of damages which

is sufficiently burdensome on potential sellers that sellers will choose to comply with the disclosure requirements rather than risk paying the damages required by the fraud remedy. Put more succinctly, the fraud remedies of Section 12(2) and Rule 10b-5 function by deterring violations.

The importance of detering violations cannot be overemphasized: investors need accurate and adequate information in order to make informed choices; and capital will be allocated efficiently in the markets only if investors are able to make informed choices. Generally speaking, a market will be efficient only if it matches projects, sellers and funds until, at the margin, returns

are equal.[5] If the fraud remedies do not deter potential violators, dishonest and incompetent sellers of securities will be able to make the same representations about the quality of, and potential return from, their securities as honest and competent sellers make about theirs. Because verification by investors of the statements made by sellers is costly, at best difficult and usually does not occur, the effect of fraud will be that investors will not be able to distinguish between low quality and high quality securities. As a result, some funds will flow into lower quality investments.

We want to be careful, however,

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[5] Easterbrook and Fischel, Mandatory Disclosure and the Protection of Investors, 70 U.Va. L.R. 669, 673 (1984)

to note that while we say that the primary function of the fraud remedies is deterrence, we do not say that the compensation of investors who have been defrauded is not also a function. Compensation is a function, but a secondary one. It is secondary because the act of compensating investors who have lost money as a result of fraud does not in and of itself promote the general purpose of providing accurate and adequate information. The compensatory aspect of the fraud remedy comes into play only if the deterrence factor has failed. In effect, the compensatory aspect of the fraud remedies merely redresses a wrong already committed when the seller sold securities without full and fair disclosure. At that point in time, it is too late to be concerned with how to make sellers provide accurate informa-

tion.

Accordingly, when damage remedies are being shaped, the remedies should be designed so that, within the boundaries set by the statutory language, the remedies will best accomplish their primary function of promoting full and fair disclosure; that is, the fraud remedies should be shaped so that they function in a manner that they will deter violations.

A look at the legislative history is useful at this point. The legislative history supports the views that Congress, in developing the fraud remedies, was focusing on deterring violations, not on compensating investors; that Congress wanted the fraud remedies to have impact on sellers of securities at the time those sellers were deciding what and how much to disclose; and that the impact

would have the effect of deterring violations. For example, the House Report on the Securities Act makes clear that the function of the civil liabilities in Section 12(2) is to deter violations. The theory is that the threat of harsh remedies would affect the conduct of those who sell securities and cause them to make full disclosure.

> The character of civil liabilities imposed by this bill. . . consists of a requirement that all of those responsible for statements upon the face of which the public is solicited to invest its money shall be held to standards like those imposed by law upon a fiduciary. . . If it be said that the imposition of such responsibilities upon these persons will be to alter the corporate organization and corporate practice in this country, such a result is only what your committee expects.

H.R.Rep. No. 85, 73d Cong., 1st Sess.5 (1933) (accompanying H.R. 5480), at 5 (emphasis supplied)

This Court has acknowledged that the primary function of the fraud remedies was to assure that investors were provided with accurate information. In TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 448 (1976), the Court discussed Rule 14a-9, which is the fraud remedy under the proxy provisions of the Exchange Act and said that the "broad remedial purpose" of the fraud remedy was "to ensure disclosures. . . in order to enable shareholders to make an informed choice." While TSC did not deal with the issue of the relative importance of deterrence and compensation, we believe that implicit in a statement that the function of a fraud remedy is ensuring accurate disclosures is the idea that compensation would be only a secondary function of the remedy.

Although this Court has not directly discussed the relative importance of the deterrence and compensation functions of the fraud remedies, lower courts have, and have held that the primary purpose is deterrence. In Globus v. Law Research Service, 418 F.2d 1276, 1288 (2nd Cir. 1969), cert. denied 397 U.S. 913 (1970), the Second Circuit said:

> Civil liability under [the Securities Act] was designed not so much to compensate the defrauded purchaser as to promote enforcement of the Act and to deter negligence by providing a penalty for those who fail in their duties.

418 F.2d at 1288

Similarly, in Feit v. Leasco Data Processing Equipment Corporation, 332 F.Supp. 544, 567 (E.D. N.Y. 1971) the Court said:

> The principal purpose of civil liability in the 1933 Act is, in fact, deterrent rather than compensatory.

332 F.Supp. at 567

A DAMAGE REMEDY WHICH FURTHERS DETERRENCE SHOULD BE CHOSEN OVER ONE WHICH MERELY COMPENSATES VICTIMS

The issue of whether deterrence is the primary function of the fraud remedies becomes important only when the measure of damages calculated under a deterrence theory differs from that calculated under a compensation theory. Most certainly, logic would dictate that if the primary function of the fraud remedies is to deter violations, the remedy which best accomplishes that function while staying within the boundaries imposed by the statutory language should be chosen. Moreover,

it is, of course, a basic rule of statutory interpretation that a statute should be construed to achieve its purposes. In United Housing Foundation v. Forman, 421 U.S. 837, 849 (1975) this Court said that interpreting the Securities Act and the Exchange Act involved a process of "construing these Acts against a background of their purpose."

We have found no case where this Court dealt with the issue of which damage remedy to choose where one damage remedy is based on a theory of deterrence and the other on compensation. But this Court has dealt with a similar issue. In Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128 (1972), the Court indicated which damage remedy it would choose as between one which imple-

mented a policy which would compensate the victim and one which implemented a policy which would prevent unjust enrichment of the fraudulent party. The remedy which would prevent unjust enrichment would more than compensate the victim for his loss. Nevertheless, it was the one to be selected. Affiliated Ute involved a defrauded seller of securities, and this Court indicated that the usual measure of damages in a securities fraud action is the out-of-pocket measure. However, this Court said that the usual rule does not apply in a situation where the out-of-pocket measure would unjustly enrich the fraudulent party.

> Where the defendant has received more than the seller's actual loss. . . damages are in the amount of seller's profit.

id. at 155

Although the Court did not elaborate on this statement, nevertheless we believe that the Court's language fully supports four related propositions.

First, any damage remedy should focus on the impact of the remedy on the fraudulent party. Janagin v. Taylor, 344 F.2d 781 (1st Cir. 1965) cert. denied 382 U.S. 879 (1965), which was cited with approval in Affiliated Ute, involved the same fact situation as Affiliated Ute (i.e. the purchaser of securities committed the fraud). The First Circuit, in shaping a damage remedy, focused on the impact on the wrongdoer: "it is simple equity that a wrongdoer should disgorge his fraudulent enrichment." id at 786

Second, full compensation of an investor's loss does not set an outer

limit on the damages which can be awarded under the securities laws.

Third, when damages calculated on a theory which implements a policy of compensating the investor are less than damages calculated on a theory which implements another, more important policy, the damages remedy which furthers the other more important policy should be chosen.

Fourth, a damage remedy which awards a victim more than his out-of-pocket loss in order to vindicate a more important policy does not conflict with the language of the statutes relating to the amount of damages (Section 28 of the Exchange Act -- "actual damages;" Section 12(2) -- "consideration paid. . . less the amount of income." Thus, the remedy stays within the boundaries set

by the statutory language.

REDUCING A DAMAGE AWARD BY TAX BENEFITS SERIOUSLY UNDERMINES DETERRENCE

Because it is clear that the remedy which best implements deterrence should be chosen, it is necessary to look at the two available remedies (one which reduces the award by tax benefits, the other which does not) to determine which more effectively furthers the policy of deterrence.

In order to understand how a damage remedy implements a policy of deterrence it is necessary to understand two aspects of deterrence.

First, in order to determine the deterrent force fo a particular remedy, it is necessary to understand how the damage remedy impacts the seller who commits the fraud. (How the remedy

affects the investor is not relevant to an inquiry about deterrence.)

Second, the way to determine the deterrent force of any particular damage remedy is to measure the difference between how the remedy treats those who obey and those who disobey. Obviously, the smaller the difference, the less the deterrent force of the damage remedy. And if the difference is small, the damage remedy will not deter potential violators at all. That is, if the damage remedy reduces the difference between complying and not complying to a point where it is not significant, and if there are likely to be gains from violating the law (i.e. if misrepresenting the facts will make it easier to sell the securities), then one may as well violate

the law and make the misrepresentations.[6]

Reducing damage awards by the amount of tax benefits which an investor receives necessarily reduces the deterrent force of the fraud remedies; in some cases, completely eliminates it. This is because the tax benefits (which reduce the amount the fraudulent seller must pay) are not out-of-pocket costs to the seller; they cost the seller nothing. This diminution in deterrent force is created by the fact that the tax losses are foreseeable by the seller at the time the securities are sold.

For example, if the seller of securities were selling tax shelter securities where the tax benefits flow

[6]See Easterbrook and Fischel, supra, at 684

directly through to the investor, the seller would realize that because of the tax benefits, he would never have to repay all of the money he obtained through his fraud. And this seller would also realize that if the shelter were deep enough (that is, if it provided sufficiently large tax losses), he might have to pay back only a small fraction of what he obtained by fraud, or perhaps nothing at all. This seller can reasonably ask himself: why not misrepresent the facts if doing so helps to sell the securities? If he is sued, the worst that can happen is that he would have to give back only part of what he obtained by fraud; and sometimes, he will not have to give back anything at all. So, from his point of view, why not commit fraud?

We believe that a damage remedy which allows tax benefits to be deducted from the damage award conflicts with the goal of deterrence which underlies the fraud remedies of Section 12(2) and Rule 10b-5 and should not be allowed.

THE SELLER'S EFFORTS IN PRODUCING TAX LOSSES ARE NOT OF THE TYPE WHICH JUSTIFY REDUCING DAMAGES AS A RESULT OF SUCH LOSSES

We recognize that a theory of damages based upon deterrence is not

without limits. Under certain circumstances, a damage award will be reduced even though deterrence is the primary function of the damage remedy.

Pertinent here are the cases which involve the same fact situation as Affiliated Ute. Those cases involve fraud by a buyer of securities. After the fraudulent transaction, the value of the securities increases while the buyer holds them. The increase was not foreseeable at the time of the transaction. The victim sues to recover not only his out-of-pocket loss (i.e., difference between the real value of the securities at the time of sale and the sale price), but also the unforeseen increase in value after the sale. The fraudulent buyer does not contest that he owes the victim the out-of-pocket cost. But he argues that he should not pay some or all of

the increase in value which occurred after the sale because the fraudulent buyer was responsible for the increase. Typically, he claims that he is responsible because he managed the business in question and did so efficiently, thereby enhancing the value of the securities. The fraudulent buyer claims that the victim should not get the benefit of what the buyer's efforts have produced.

These cases are relevant here because in this case the seller argues that he has provided the tax losses to the investors; and that the investor should not get the benefit of what the seller has produced. (The investor here, of course, will keep the tax losses, but would lose the benefit of them if the tax losses are used to reduce damages.)

Case law, however, makes clear that a fraudulent buyer can reduce damages as a result of benefits he produces only if the fraudulent party can show the benefits resulted from "extraordinary gain" resulting from "special efforts." The cases hold the fraudulent buyer need not pay as damages any increase in value which can be attributed to his "aggressive and enterprising management ability" Rochez Bros. Inc. v. Rhodes, 491 F.2d 402, 412 (3rd Cir., 1974). He cannot reduce the damages even though he managed the business if "no extra-ordinary gains are attributable" to him and he merely "received his salary for his personal efforts which would have been his regular duty." Janigan v. Taylor, supra, 786

While it is sound policy to allow

a defendant to reduce his damages to the extent that he can show that his extraordinary gain produced by his special efforts, that policy is not applicable to this case in which the fraudulent party produced tax losses. There are four reasons for this result.

First, in this case the seller did not cause any "increase in value;" rather he caused losses; he managed the project so badly that it was ultimately lost to foreclosure.

Second, it was undoubtedly the case here as it is in a typical tax shelter that tax losses, in large part, resulted from interest and/or depreciation deductions, two items which do not involve the seller's efforts and which are available in every situation where property is owned and is acquired, in

whole or in part, for debt. (In any case, these are deductions intended to reflect real economic costs incurred by the investor; they are not gains, much less "extraordinary gains.")

Third, it was undoubtedly true here as it is in most tax shelters which fail that most of the tax losses in addition to those generated by interest and depreciation, resulted from the fact that the business of the tax shelter being operated poorly at a level below breakeven operations. The cash losses from operations translate directly into tax losses. If the test which allows a fraudulent party to reduce damages is "aggressive and enterprising management ability," then managing a business so that it loses money, and thereby generates tax losses, most certainly

should not satisfy. And again, these taxes reflect real economic costs incurred by the investors and do not represent "extraordinary gain."

Fourth, the tax losses in this case were specifically foreseeable. By contrast the "extraordinary gain" generated by the "special efforts" of the fraudulent party after the fraudulent transaction had been completed were not foreseeable.

Accordingly, the seller's efforts in this case are not of the type which would allow the tax losses to reduce a damage award.[6]

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[6]Another limitation on the amount of damages which may be awarded on a deterrence theory relates to dividends or distributions which are in effect a return of the investor's capital. But no cash distributions or dividends were made in this case and thus this doctrine is not relevant here. In any case, the Court of Appeals correctly noted that tax losses should not be treated as a return of capital. (J.A. A-18)

ALLOWING TAX LOSSES TO REDUCE A DAMAGE AWARD WILL REWARD FRAUD

Securities fraud actions usually arise in the context of a situation where the fraudulent seller makes misrepresentations as to the financial viability of the project. Typically, the project operates poorly and it is the very facts which were misrepresented or omitted which cause the poor operational results. (In this case, the fraudulent seller represented that the construction loan would bear a fixed rate of interest at 9½%. In fact, the interest rate floated at 4% above prime. The project encountered financial difficulties in large part because of excessive interest costs

as a result of the floating rate loan.)[7] Because the project operates at a loss on a cash basis, tax losses passed through to investors are greater than projected. These larger than expected losses are directly related to the seller's fraud.

If the tax losses are used to reduce the damage award, the seller in effect becomes the beneficiary of his own fraud. The larger the fraud, the larger the tax losses; and the larger tax losses, the less the seller must pay out of his own pocket in damages. Ironically, the ultimate effect or reducing a damage award by tax benefits would be to reward the fraud.

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[7] J.A. D-9

ADVERSE EFFECTS OF A RULE WHICH REDUCES A DAMAGE AWARD BY TAX BENEFITS

One of the problems created by a damage formulation which erodes the deterrent effect of the fraud remedies is that it leads to misallocation of capital. If there is little or no deterrent force to the fraud remedy, dishonest sellers will misrepresent facts and make false claims. This will lead to investment based on inaccurate and inadequate information and investors' funds will flow to dishonest promotors. One of the effects which Congress intended when it decided to require that investors be given accurate and adequate information was that capital would be allocated efficiently and the allocation process would not be distorted by false

and misleading disclosures. The Senate Report on the Securities Act indicated that an "aim [of the bill] is to protect honest promotors, seeking capital by honest presentation, from the competition afforded by dishonest securities offered to the ...blic through dishonest promotion." S.Rep. 47, 73d Cong. 1st Sess. 1 (1933) (accompanying S. 875).

The problem of misallocation is exacerbated by the fact that a remedy which reduces the damage award by tax benefits is limited to one area of the securities market. Outside of the tax shelter securities area, tax benefits do not reduce the amount of the award. It should necessarily follow that fraudulent sellers of securities will seek to sell more and more tax shelter

securities, since their exposure will be less if they sell those rather than other securities.

A COMMENT ON THE COLLATERAL SOURCE RULE

In this brief, we have focused on the policy considerations which are expressed in the legislative history of and the cases construing the Securities Act and the Exchange Act. We have not focused on the collateral source rule, because we believe that resort to that rule is unnecessary. We believe that the policies underlying Federal securities laws make clear that the seller should not be given credit for the tax benefits which an investor recovers. And this is true even though

the seller has produced the tax losses which give rise to those tax benefits.

However, the considerations underlying the collateral source rule are essentially the same as those that we have suggested above in our argument. As a result, if this case we analyzed in terms of the collateral source rule, the result should be the same as the result we suggest above.

In this connection, as a preliminary matter, it should be noted that the case law dealing with the collateral source rule does not apply mechanical distinctions in order to determine whether a source is collateral. In deciding whether a source is collateral, the courts look to policy considerations. See, for example, Haughton v. Blackships, Inc., 462 F.2d 788, 790 (3rd Cir. 1972) where

the court said: "Application of the collateral source rule depends less on the source of the funds than upon the character of the benefits received."

One of the policies which the collateral source rule is designed to implement is the goal of deterring violations. Restatement of Torts, Second, §§901 and 920A (1965).

Another policy implemented by the collateral source rule is related to and in a sense is part of deterrence. It is the policy of making sure that the wrongdoer bears the responsibility for paying the victim. He can do this by paying the victim directly or by having his insurance company do so (in effect he actually pays the victim indirectly by paying his insurance premium). But he is not deemed to have

shouldered the responsibility if the victim's insurance pays or if the government, as a result of social welfare legislation, pays. In effect, the collateral source doctrine requires that the payment to the victim have an impact on the defendant. See Restatement of Torts, Second §920A (1965).

These policies of deterrence and impact on the wrongdoer are essentially the same policies as those which underly the argument above and they lead to the same conclusion. If this case were analyzed in terms of the collateral source rule, policy considerations would require that tax benefits be considered collateral and hence ignored.

CONCLUSION

Tax benefits should not reduce damage awards under Section 12(2) or Rule 10b-5. The decision of the Court of Appeals should be reversed.

Dated: January 4, 1986

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